Perpetual Bonds: Capital Structure Balancing Alternative

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The cost of capital and leverage are two key considerations for a company in determining its capital structure. A company will seek a balance between its liabilities and equity, with their corresponding costs, which make up the weighted average cost of capital (WACC). Aside from tax deductibility, debt or liabilities incur lower costs due to the non-dilution of shareholders' rights on net profit. However, the lower cost of debt will not directly imply that a company can max out on its debt leveraging. High leverage will incur financial pressure and, furthermore, can reduce a company's financial flexibility. It is often the case that the regulator or creditors require a certain limit on a company's leverage level. The scarcity of liquidity in the market also adds to the complexity of the issue.

In this situation, a company may feel the need for a financial instrument that possesses a non-dilutive feature like debt, but still provides flexibility on the balance sheet like equity. This need drove the creation of hybrid capital. By its basic definition, hybrid capital acts as a debt instrument but can be classified as equity, contingent to its degree of permanence and seniority. One of the most widely used types of hybrid capital is the perpetual bond. As the name implies, a perpetual bond is a bond issued without any due date, while coupon payments are made periodically for the life of the bond, or in this case, perpetually. When it was initially introduced, this was done literally as defined, but later, as we found, modifications were made or features were added to the instrument in order to raise market demand. The other advantage gained from the use of a perpetual bond is the company's capital strengthening, where the perpetual bond has the characteristic of being outstanding for a long period of time, possesses a coupon deferral option (much like a share dividend, which is under the company's full discretion) and is subordinated to common debt. Cost-wise, a perpetual bond will be less expensive due to it being a non-dilutive quasi-equity, and will bring efficiency in terms of weighted average cost of capital. Ultimately, deploying an equity-like instrument will increase financial flexibility. Because a perpetual bond is essentially debt, the payable interest will be tax deductible.

A perpetual bond is issued without a due date or is due very far in the future, usually with a call option from the issuer five or 10 years after issuance. It also has a step-up rate in its coupon after the first call date. In its payment priority, a perpetual bond is deeply subordinated and senior only to equity. The issuer's full discretion to defer coupons, or the event of deferral itself, will not constitute a default or cross-default trigger.

As financial instruments are usually assessed from four angles – accounting treatment, rating treatment, tax treatment, and legal treatment – the use of perpetual bonds is best compared to debt and equity instruments. Debt instruments, which are generally issued in the form of senior unsecured bonds or medium-term notes (MTN), are treated as 100%-debt (non-dilutive) under accounting principles, as opposed to shares which are 100% equity and dilutive. A perpetual bond is in the middle of this equity-debt spectrum, having been classified as equity while being non-dilutive like bonds. From the rating point of view, both equity and liability are assessed in a straightforward fashion; with gradual treatment applied in the perpetual bond analysis, assigning a mix of equity and liability characteristics – either by assigning a specific weight percentage or by having a discretionary consideration based on the details of the perpetual bond's terms and conditions. From the tax perspective, both bonds and perpetual bonds have tax-deductible coupon payments, while share dividends cannot be used as a deductive component in the pretax income structure.

To attain equity treatment under international finance reporting standards, a perpetual bond should not be puttable by the investor. Having a puttable option means the discretion is no longer in the issuer's hands and the issuer can bear an obligation to redeem if the option is exercised by the investor. This condition, therefore, will imply a debt instrument. On the other hand, the instrument can have a call option, exercisable by the issuer. Generally, today's perpetual bonds are equipped with a call option to be more enticing for investors, and go further by having a step-up rate after the first call date, and are exercisable if the perpetual bond is not redeemed. A high step-up in the situation where the perpetual bond is not called would not hinder the instrument from being classified as equity under accounting standard IAS 32. The economic incentive to redeem the instrument (to avoid a penalty in the form of paying a higher coupon) is not a contractual obligation. The obligation to pay on the issuer's liquidation does not mean the perpetual bond cannot be treated as equity, as a perpetual bond ranks higher and in some cases has senior unsecured status, such as perpetual bonds issued by the China Railway Corporation. In order for the perpetual bond to be classified as equity from the point of view of accounting or rating agencies, the coupon must be deferrable. The deferred coupon will still be outstanding and cumulative, and the issuer can settle the deferred coupon with cash or any other financial means later on.

Perpetual bonds also have what is called a dividend pusher/stopper. A dividend pusher is a combination of a trigger where the coupon must be paid as a consequence of a decision by the general shareholders' meeting to pay the share dividend. A dividend stopper, on the other hand, is a combination of a trigger that halts a share dividend payment as a cause of the issuer's choice to defer the payment of the perpetual bond's coupon. The dividend pusher/stopper will not impede the perpetual bond from having an equity feature, with the assumption that the issuer has full discretion for dividend payment. But, in the case that a perpetual bond's coupon cannot be deferred and the instrument has a contractual obligation to be paid, the instrument can shift into debt classification. A dividend pusher or stopper is a determining factor on whether the hybrid instrument, such as a perpetual bond, is not subordinated under the shareholders. Thus, to ensure that the perpetual bond does not rank below the shareholder, a dividend pusher/stopper can be included in the instrument's terms and conditions. From an accounting perspective there is no particular boundary or special requirement in designing the dividend pusher/stopper.

Lately, perpetual bonds have shown a pick-up in real world application. Generally, the instrument was issued to fund mergers and acquisitions and/or capital expenditure. As the instrument is classified as equity or quasi-equity, it does not add any financial pressure (i.e. increasing leverage), and a perpetual bond could be used to maintain the issuer's credit rating. Other than the advantage of being non-dilutive and tax-deductible, the other objective is to take advantage of a lower interest rate to raise permanent quasi-equity.

There are many instances of perpetual bond issuance in the Asia Pacific region, whether by blue chips, mid-cap companies, state-owned enterprises, listed companies or private ones. A number of perpetual bonds come from public utilities, oil and gas, manufacturing, and real estate industries, ranging from investment grade rated to high yield. Several state owned enterprises in Asia have utilized perpetual bonds to raise non-dilutive funds to bolster their balance sheets.

Indonesia Air Asia (IAA) in 2015 conducted a perpetual bond transaction to address its negative equity issue at that time. It converted part of a parent loan into perpetual bonds, which, in effect, lifted its equity to a positive level. This perpetual bond was direct, unsecured and unsubordinated, with a coupon of 12% per annum paid semi-annually and a call option at the end of seventh year with a step-up of 500 bps, where the coupon was deferrable and the deferred coupons were cumulative and compounded. These perpetual bonds, however, were not traded in the exchange.

Looking at the features and advantages of perpetual bonds, there is a demand for clear guidelines for their application in the domestic market. The guidelines should lay out how the perpetual bond should be treated under the prevailing legal and accounting principles, and how it will be structured to cater to both the issuer and investor's risk-reward appetite. Pioneering use of the instrument can also set a positive precedent for later development and any tweaks needed. Hopefully, clarity in the guidelines improves and the instruments begin to show proliferation, and the domestic market for this instrument can be set up.

PEFINDO is also in the view that hybrid instruments such as perpetual bonds warrant close scrutiny of several key factors to determine their standing in the debt-equity spectrum. The instruments' economic impact and the regulator's views are most relevant, while its nomenclature (or literal naming) is of secondary consideration. A transaction labeled debt for accounting and tax purposes can still be regarded as equity for rating purposes, and vice versa. Regulators can also assume a critical role as they can intervene in key factors such as maximum issuance or coupon payment structure that can impact the classification of perpetual bonds. In short, we are looking at items such as coupon payment terms and conditions, the permanence level of the capital, and the level of subordination (especially in the event of default). Unfortunately, perpetual bond use in the domestic corporate universe has yet to attract any interest and a live application could not be rendered. We are of the view that, given no issues with market acceptance, perpetual bonds can offer a solution to the capitalization problem.